ST 99-6
Tax Type: SALES TAX
Issue: Machinery & Equipment Exemption - Manufacturing

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS v. **"HARD AS A ROCK, INC.",** Taxpayer	No. 97-ST-0000 NTL: SF-199600000000000

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Charles Hickmann, Special Assistant Attorney General for the Illinois Department of Revenue; Ms. Iris Miranda-Kirschner Esq. for "Hard As A Rock, Inc."

Synopsis:

This matter comes on for hearing pursuant to taxpayer's timely protest of the Notice of Tax Liability, SF-199600000000000 ("NTL") dated December 18, 19xx for the audit period of November 1, 1994 through November 30, 1994 for Use Tax due on the purchases of two front-end loaders. The issue at hearing is whether the taxpayer, a ready-mix manufacturer, is entitled to the Manufacturing Machinery and Equipment Exemption of the Use Tax Act ("M & E exemption") on its purchases of two front-end loaders which are used to charge the bins of taxpayer's ready-mix concrete batch plant.

Following the submission of all evidence and a review of the record and briefs filed herein, it is my determination that the purchases of these two front-end loaders are exempt from Use Tax, therefore, the Notice of Tax Liability should be cancelled.

Findings of Fact:

1. The Department established its *prima facie* case, inclusive of all jurisdictional elements, by the admission of the Correction of Return, Form SC-10-K for the audit period of 11/1/94 through 11/30/94. The liability reflected on this SC-10-K relates solely to the purchases of the two front-end loaders at issue. Department Ex. No. 1; Tr. p. 8.
2. Taxpayer manufactures ready-mix concrete for sale to end-users. Tr. pp. 10, 16.
3. Ready-mix concrete is prepared pursuant to a mix design. Tr. p. 22. The component parts of ready-mix concrete are water, sand, cement, add mixture, crushed rock or gravel, and special chemicals, if necessary. Tr. pp. 20-22.
4. Coarse aggregate material is delivered to the taxpayer's location by railroad car and dump trucks. Tr. p. 28; Taxpayer Ex. No. 8.
5. Cement is delivered by a pneumatic tanker, which blows the cement into taxpayer's cement silos. Tr. pp. 29, 30.
6. The front-end loaders in dispute do not unload or move the coarse aggregate out of the railroad cars. Tr. p. 26; Taxpayer's Ex. No. 4. Taxpayer owns two additional front-end loaders, not at issue in the present case, which unload the railroad cars and move coarse aggregate during pre-production phases. Tr. pp. 26, 86.

7. Taxpayer has a primary batch plant and a secondary batch plant for manufacturing ready-mix concrete. Tr. pp. 27-28. The two front-end loaders at issue do not transfer materials between these two batch plants. Tr. pp. 27, 29.
8. The front-end loaders at issue pick up the material off of the ground and load the bin of the cement batch plant. Filling these bins or the act of dumping these materials into the bins is referred to in the industry as "charging the bins." Tr. p. 85.
9. This material is transported upwards from the first bin onto a conveyer belt for approximately 20 or 25 feet and is dumped into a second bin. From this second bin the material is placed into a weigh batcher, which then measures it. The measured material is then placed onto a much shorter conveyer belt, which takes it to the ready-mix truck. Tr. pp. 71, 85.
10. Material cannot be loaded into the bin, which is approximately eight to nine feet above the ground, without equipment to pick it up off the ground and load it in the bin. Tr. pp. 23, 24.
11. The batch plant serves the function of ensuring that the requisite components of concrete, which could be the cement, the aggregate, fly ash, chemicals, and the water are placed into the truck for mixing in their proper proportions. Tr. pp. 40, 78; Taxpayer Ex. No. 25.
12. The batch plant not only places the proper amount of material into the truck for mixing in their proper proportions, it also coordinates the timing of these additions. Tr. pp. 78-79. If the timing is not coordinated properly, a poor quality product will result. Tr. p. 79.

13. The first time that all of the ingredients are in contact with one another is inside the truck. Tr. p. 78.

14. Since the second batch plant is not automated, the man operating the front-end loader is not only charging the bins, he is performing a batching operation. Tr. p. 47.

15. When using the second batch plant, the front-end loader loads the coarse ingredients directly onto the scale, which actually weighs and batches the material directly, it is not merely a holder hopper or a bin. Tr. pp. 46, 48, 49. Taxpayer Ex. No. 35.

16. The front-end loaders at issue are used primarily in the charging phase of the production of ready-mix concrete. Tr. pp. 30, 31, 50, 51, 81; Taxpayer Ex Nos. 11-13, 16. The front–end loaders in question load trucks less than 10% of the time. Tr. p. 75.

Conclusions of Law:

The Department prepared corrected returns for Use Tax liability pursuant to section 4 of the Retailers' Occupation Tax (hereinafter ROT) Act 35 **ILCS** 120/4. Said section is incorporated by reference in the Use Tax Act via section 12 thereof. 35 **ILCS** 105/12.

In the case at bar, the taxpayer is challenging the assessment by the Department of Use Tax, penalty and interest on the purchase of two front-end loaders. The taxpayer asserts that the purchases are exempt from Use Tax based upon the manufacturing machinery and equipment exemption as set forth in section 3-5 of the Use Tax Act as follows:

> Sec. 3-5. Exemptions. Use of the following tangible personal property is exempt from the tax imposed by this Act: … (18) Manufacturing and assembling machinery and equipment used primarily in the process of manufacturing or assembling tangible personal property for wholesale or

> retail sale or lease, whether that sale or lease is made directly by the manufacturer or by some other person, whether the materials used in the process are owned by the manufacturer or some other person, or whether that sale or lease is made apart from or as an incident to the seller's engaging in the service occupation of producing machines, tools, dies, jigs, patterns, gauges, or other similar items of no commercial value on special order for a particular purchaser. 35 **ILCS** 105/3-5.

The statute further provides:

> Sec. 3-50. Manufacturing an assembly exemption. The manufacturing and assembling machinery and equipment exemption includes machinery and equipment that replaces machinery and equipment in an existing manufacturing facility as well as machinery and equipment that are for use in an expanded or new manufacturing facility. 35 **ILCS** 105/3-50.

Section 3-50 of the statute defines equipment as "[a]n independent device or tool that is separate from any machinery but that is essential to an integrated manufacturing or assembling process; . . ." 35 **ILCS** 105/3-50; *also* 86 Ill. Admin. Code §130.330 (c)(3). The Department's regulation, however, clearly provides that "[t]he fact that particular machinery or equipment may be considered essential to the conduct of the business of manufacturing or assembling because its use is required by law or practical necessity does not, of itself, mean that machinery or equipment is used primarily in manufacturing or assembly." 86 Ill. Admin. Code § 130.330(d)(2)(1994). Thus, the taxpayer must not only show that a piece of equipment is essential to the manufacturing process, it must prove that it is *primarily* used in this process.

The Illinois Supreme Court has identified and examined three phrases as the "gist" of the M & E exemption: 1) "tangible personal property"; 2) "process of manufacturing or assembling"; and 3) "primarily." Van's Material Co. v. Department of Revenue, 131 Ill. 2d 196, 203 (1989). In that same opinion, the court acknowledged that

the legislature enacted the M & E exemption to give a tax exemption on capital investment thereby attracting new manufacturing facilities to Illinois and, at the same time, maintain existing facilities within the state. Chicago Tribune Co. v. Johnson, 106 Ill. 2d 63, 72 (1985); Van's Material Co., 131 Ill. 2d at 215.

It is undisputed that the taxpayer manufactures ready-mix concrete for sale to retail customers and private contractors, thus it is similarly situated to the taxpayer in Van's Material. In that opinion, the Illinois Supreme Court held that ready mix concrete constitutes tangible personal property, (Id. at 203), thus, the only issue which remains in the present case is whether the front-end loaders were primarily used in the process of manufacturing or assembling.

In the case at bar, the Department disputes the front-end loader is used in the manufacturing process. Rather, it contends that "charging" or loading the holding bins of the manufacturing (batch) plant, with sand, gravel and the other materials used to manufacture concrete, is a pre-production activity. Therefore, the purchase of this equipment falls outside the scope of the M & E exemption. Taxpayer maintains, however, that the use of the front-end loaders to charge the bin constitutes an essential and necessary part of the manufacturing process and accordingly the purchases of the front-end loaders are exempt from Use Tax. Taxpayer's brief p. 10.

The statute defines manufacturing process in the following manner:

> '[M]anufacturing process' shall mean the production of any article of tangible personal property, whether such article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by procedures commonly regarded as manufacturing, processing, fabricating, or refining which changes some existing material or materials into a material with a different form, use or name. 35 **ILCS** 105/3-50.

In Van Materials, the Court determined that "whenever labor is bestowed upon an article which results in its assuming a new form, possessing new qualities or new combinations, the process of manufacturing has taken place." Van's Material Co., 131 Ill. 2d 20708 *quoting* Dolese & Shepard Co. v. O'Connell, 257 Ill. 43, 45 (1912). The statute specifies that "[t]he manufacturing process commences with the first operation or stage of production in the series and does not end until the completion of the final product in the last operation or stage of production in the series. …" 35 **ILCS** 105/3-50(1) Accordingly, a determination of the taxability of taxpayer's use of its front-end loaders should turn on whether charging the bin with the front-end loader constitutes the first operation in the series of operations which collectively comprise the manufacturing of ready-mix concrete.

Such an interpretation is supported by the Illinois Supreme Court's analysis in Van's Material, in which the Court states: "The manufacturing process for ready-mix concrete begins when the four component parts, sand, limestone, water and cement, in specific proportions are loaded into the turning hollow drum mixer on the ready-mix concrete truck. This initial phase is referred to as the charging process. Once the charging process is completed, the second phase, referred to as the mixing process, begins." Id. at 199. While at first glance it might appear that the manufacturing process begins upon loading the truck, the Court appears to have broken down the manufacturing process into several phases including both the charging phase and the mixing phase. The initial charging phase consists of loading the component parts, in specific proportions, into the turning hollow drum mixer on the ready-mix concrete truck, thus, measuring the proper proportion of the materials is an essential part of the charging process and,

therefore, part of the manufacturing process. This determination appears to have been accepted by the Department since purchases of cement batch plants and its parts have been determined to fall within the Manufacturing Machinery and Equipment Exemption in various letter rulings, which although not binding in the case at bar, give some guidance as to the Department's past interpretation of the law. *See*, Sunshine Letter Nos. 90-0287, 6/11/90; 89-0527, 9/6/89; and 86-0065, 1/23/86.

The Department's interpretation of the M & E exemption can be discerned by looking to its regulations. Specifically, Section 130.330 (incorporated by Section 150.301(b)) notes that the use of machinery or equipment to store, convey, handle or transport materials or parts or sub-assemblies prior to their entrance into the production cycle will generally <u>not</u> be considered to be manufacturing. 86 Ill. Admin. Code §130.330(d)(4) (*emphasis added).* Nor does the use of machinery or equipment to store, convey, handle or transport finished articles of tangible personal property to be sold or leased after completion of the production cycle qualify for the exemption. 86 Ill. Admin. Code § 130.330 (d)(4)(C) & (D).

The regulations, however, allow that the following uses among others are considered to be exempt: "use of machinery or equipment to inspect, test or measure the tangible personal property to be sold where such function is an integral part of the production flow; the use of machinery and equipment to convey, handle, or transport the tangible personal property to be sold within production stations on the production line or directly between such production stations or buildings within the same plant; and the use of machinery or equipment to place the tangible personal property to be sold into the

container, package or wrapping in which such property is normally sold to the ultimate consumer thereof." 86 Ill. Admin. Code §130.330(d)(3)(C)-(E).

Pre-production activity is a taxable use under Departmental regulations, however, charging the bins of the concrete batch plant is not pre-production because it is the first step in the series of operations which constitute the manufacture of concrete. Compare this allegedly "pre-production step" to the packaging of the finished good. The Department recognizes that packaging the good is a step in the manufacturing process and, therefore, equipment that serves this purpose is exempt from Use Tax. This is true even though the transformation from raw material into finished good has been completed, i.e., there is no appreciable change in the form of the product for sale in the packaging step, because packaging a product has been determined to be an important link in the production cycle. Likewise, the equipment which charges the bins under the facts and circumstances presented here should be exempt since it is performing a task which constitutes the first link in the whole manufacturing process and is an integral part of the transformation of raw material into finished good. The use of the front-end loaders in the case at hand can be distinguished from general pre-production activities which would not be so closely linked to this transformation process, such as unloading the railroad cars or moving piles of material at the work site.

Moreover, the regulation recognizes the importance of measuring the tangible personal property and considers it an exempt use where it is an integral part of the production flow. The front-end loader operator utilizing the second batch plant plays an important role in measuring the materials by loading them in specific proportions into the bin, (which in this plant directly weighs the material), watching the scales and making

any necessary adjustments. The operator utilizing the primary batch plant does not directly read the scales to measure the material. He does, however, maintain constant contact through headphones with the batch operator to ensure that the bin is charged with sufficient material before it is transported up the conveyer belt to the scales to be weighed and loaded into the ready-mix truck. Clearly, the record reflects the front-end loaders activity in both instances is an important part of the production flow.

The Department established its *prima facie* case by offering the Correction of Returns into evidence, thereby shifting the burden of proof to the taxpayer. *See*, 35 **ILCS** 105/12. To overcome the *prima facie* case, the taxpayer must produce competent evidence, identified with taxpayer's books and records, showing that the Department's determination is incorrect. A. R. Barnes v. Department of Revenue, 173 Ill. App. 3d (1st Dist. 1988).

Statutes that exempt property or entities from taxation must be strictly construed and doubts regarding their applicability should be resolved in favor of taxation. Van's Material, 131 Ill. 2d at 216. The Department contends that the taxpayer has not met its burden in proving that the front-end loaders were primarily used in the manufacturing process, however, an examination of the record indicates otherwise. At hearing, taxpayer produced 42 photographic exhibits depicting the four front-end loaders in operation as well as the physical layout of the taxpayer's plant. The taxpayer only manufactures concrete. Thus, its work requirements are known. Moreover, the taxpayer has proven through photographic evidence that it owns a total of four front-end loaders and the record reflects that it is only contesting the Use tax imposed on the two loaders used to charge the bins. It is evident that enough equipment is at hand to handle the non-exempt

uses such as unloading the railroad cars. This photographic evidence, in conjunction with the credible testimonial evidence that thoroughly explained each phase of the manufacturing process, the role of both front-end loaders in that process and the material handling capabilities of this equipment, shifted the burden back to the Department to prove its contentions by a preponderance of the evidence. Balla v. Department of Revenue, 96 Ill. App. 3d 923 (1981) The record reflects that the Department has not met its burden.

Wherefore, for the reasons stated above, it is my recommendation that the Notice of Tax Liability should be cancelled.

Date: February 22, 1999

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Christine O'Donoghue
Administrative Law Judge